Reputation and Its Risks:
The Necessity of Managing Reputational Risk

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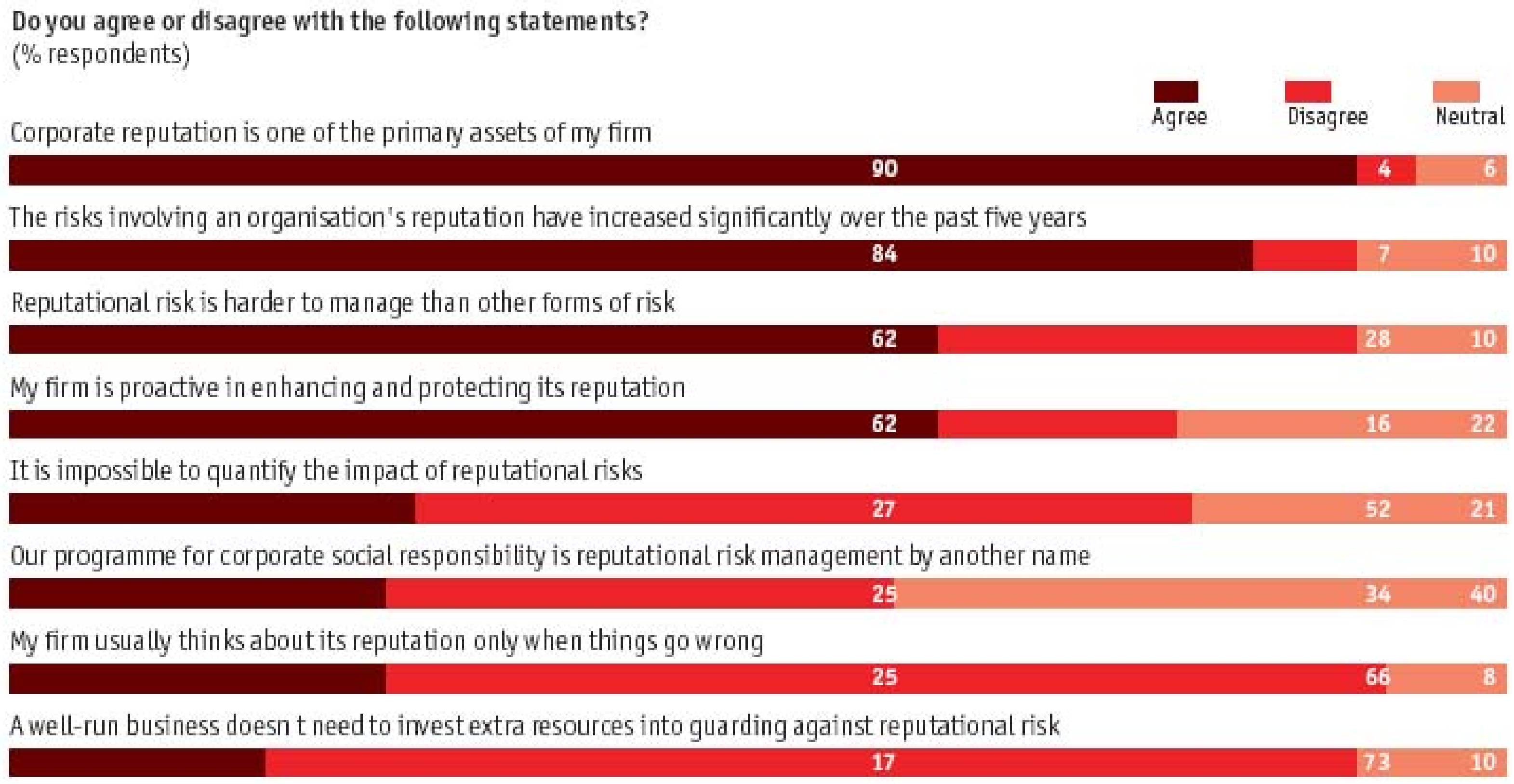
*“It takes many good deeds to build a good reputation,
and only one bad to lose it.“*

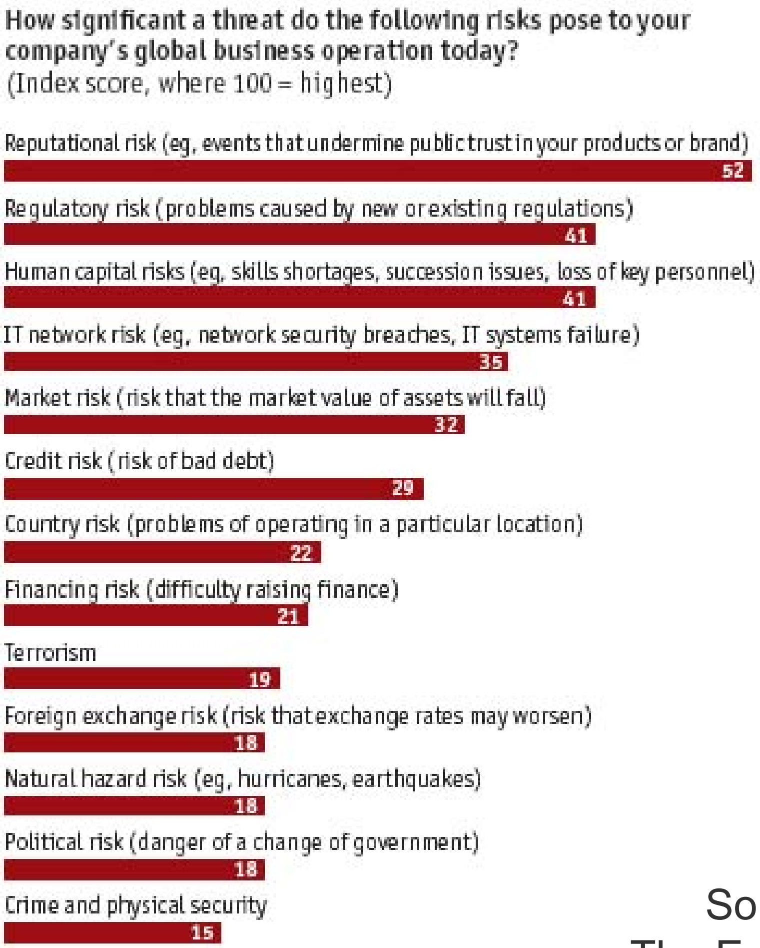
Benjamin Franklin

The Importance of Reputation and Reputational Risk



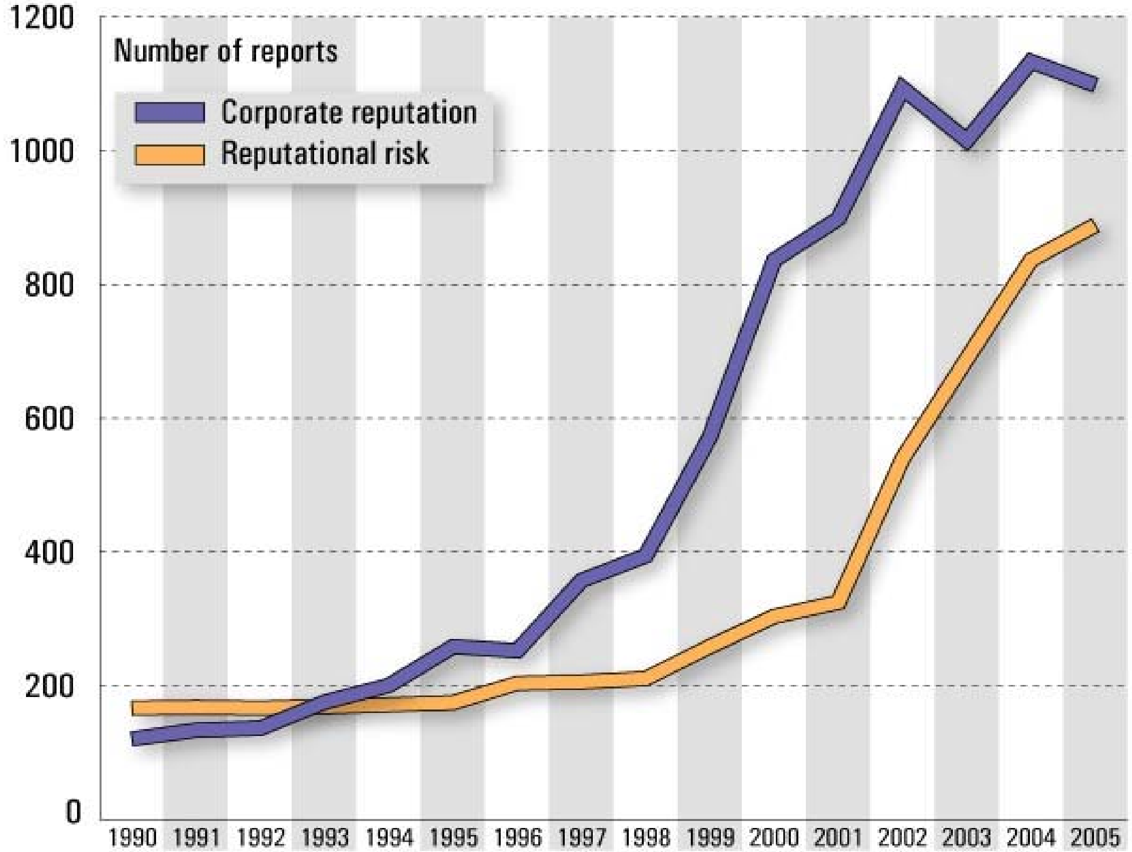
Source: „Reputation: Risk of Risks“
The Economist Intelligence Unit c.2005

Reputational Risk is the Greatest Risk of All



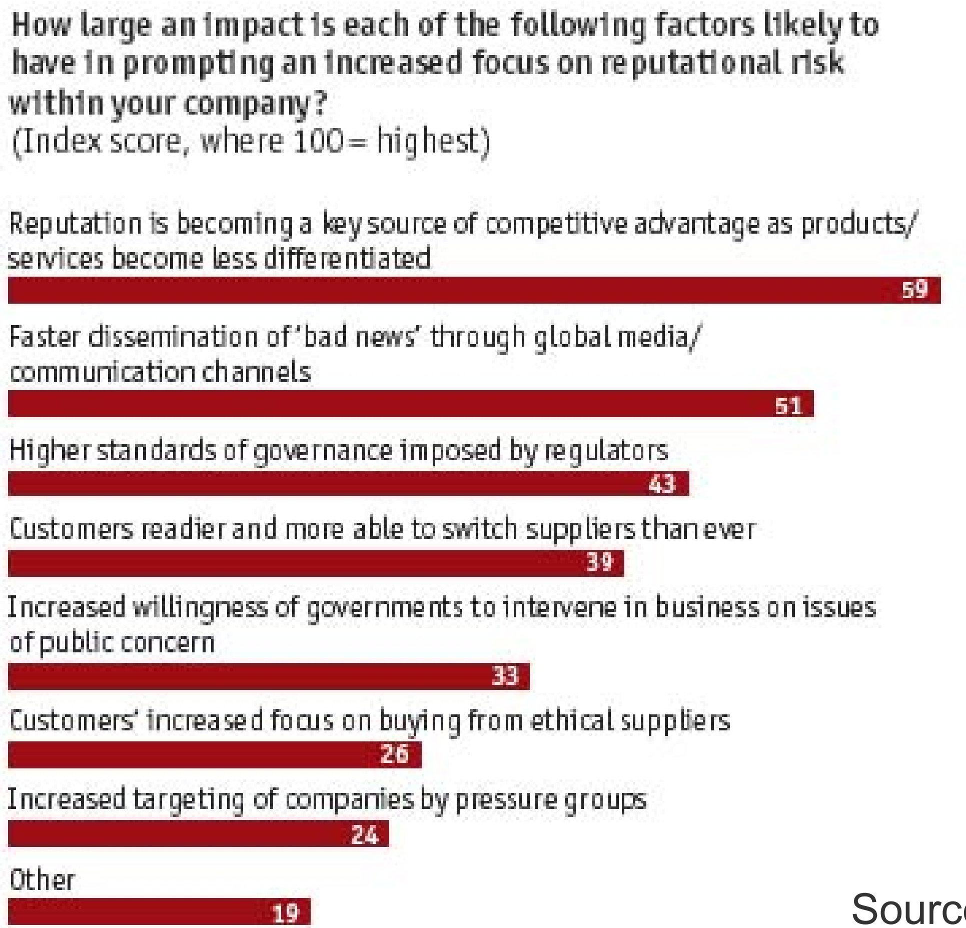
Source: „Reputation: Risk of Risks“
The Economist Intelligence Unit c.2005

Press Coverage of Corporate Reputation and Reputational Risk



Source: LexisNexis Press Center

Why Reputational Risk is Increasingly Important



Source: „Reputation of Risks“
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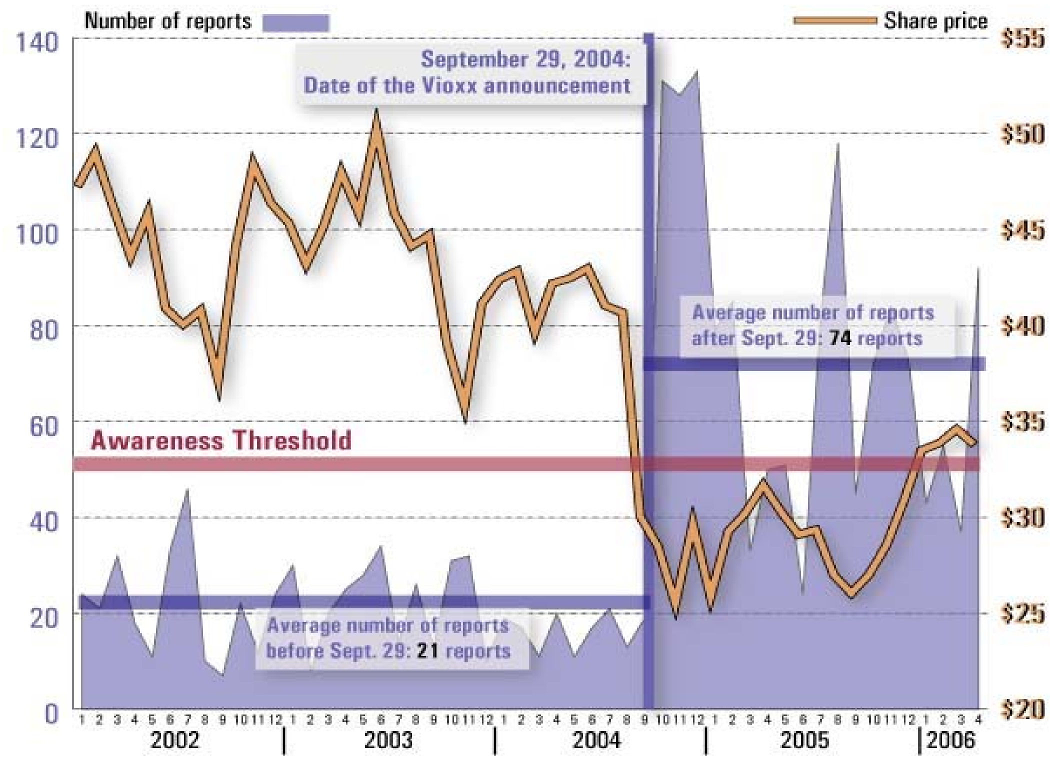
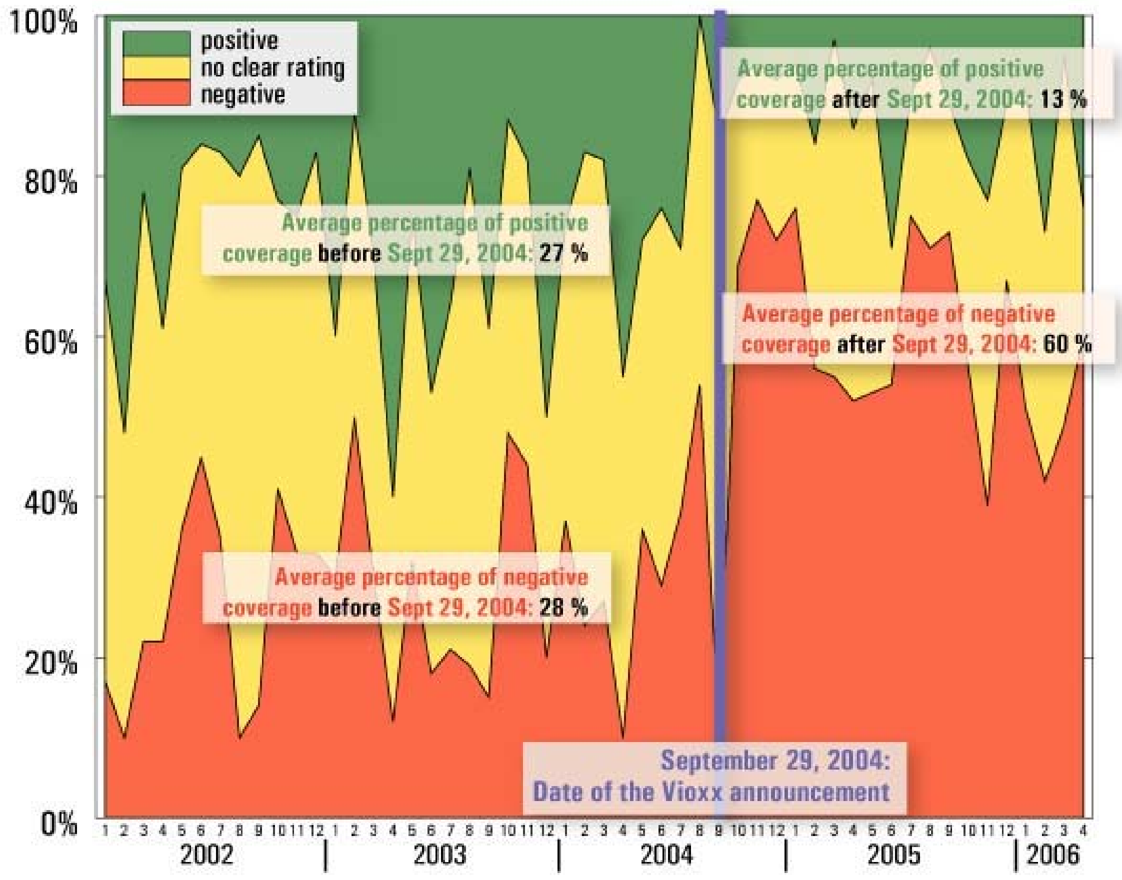
Merck's Stock Price and Level of Media Awareness



Source: Media Tenor 01/2002 - 04/2006

Basis: 2,093 reports on Merck in 10 US media

Positive vs. Negative Coverage of Merck



Source: Media Tenor 01/2002 - 04/2006

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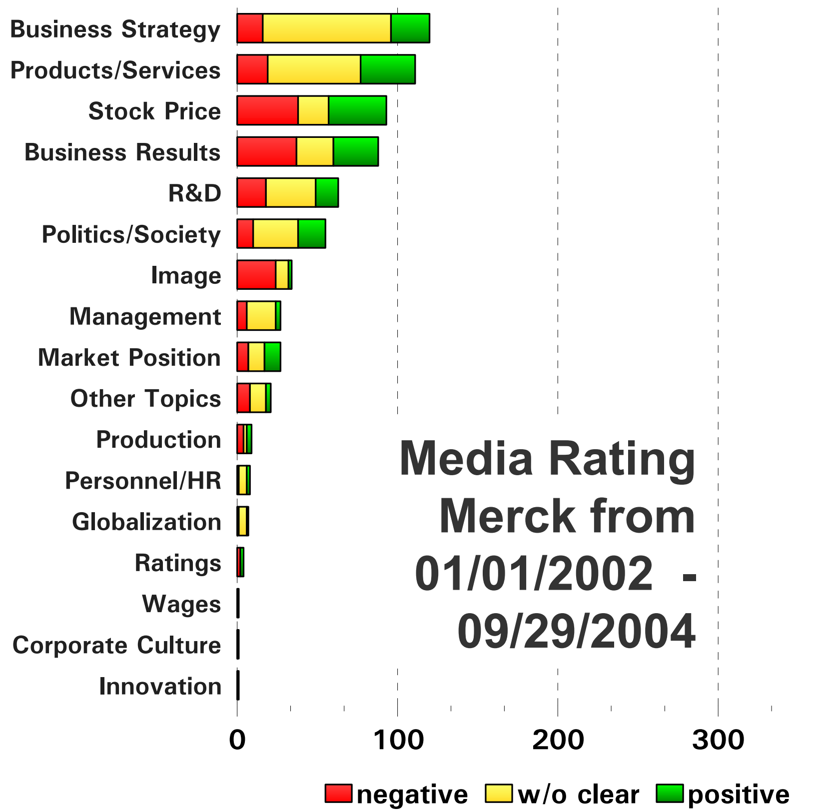
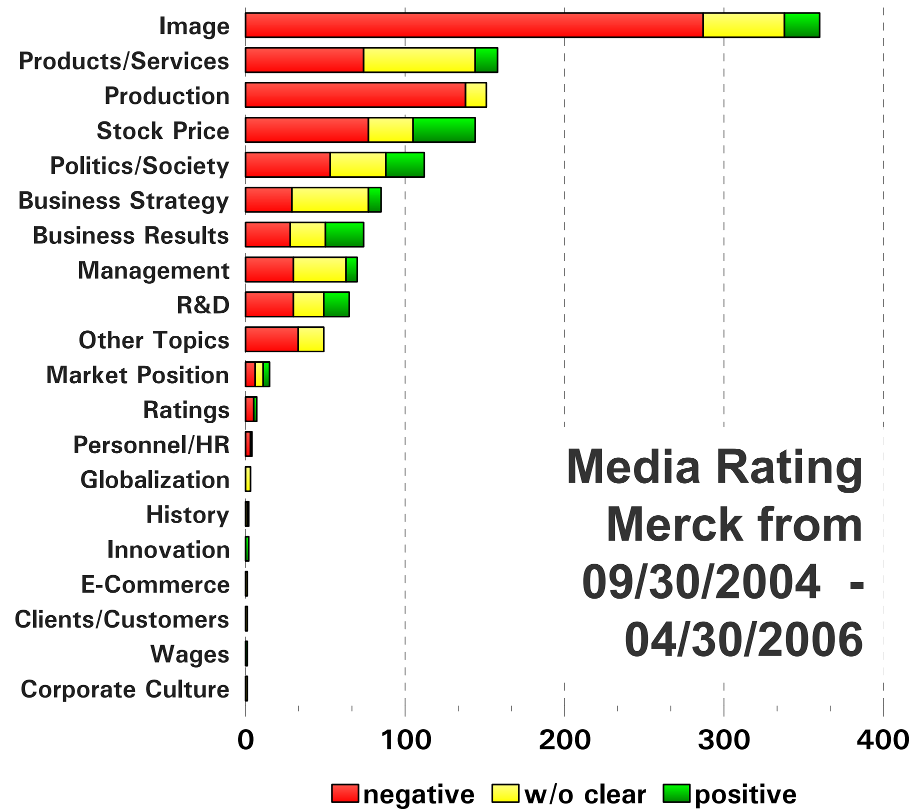
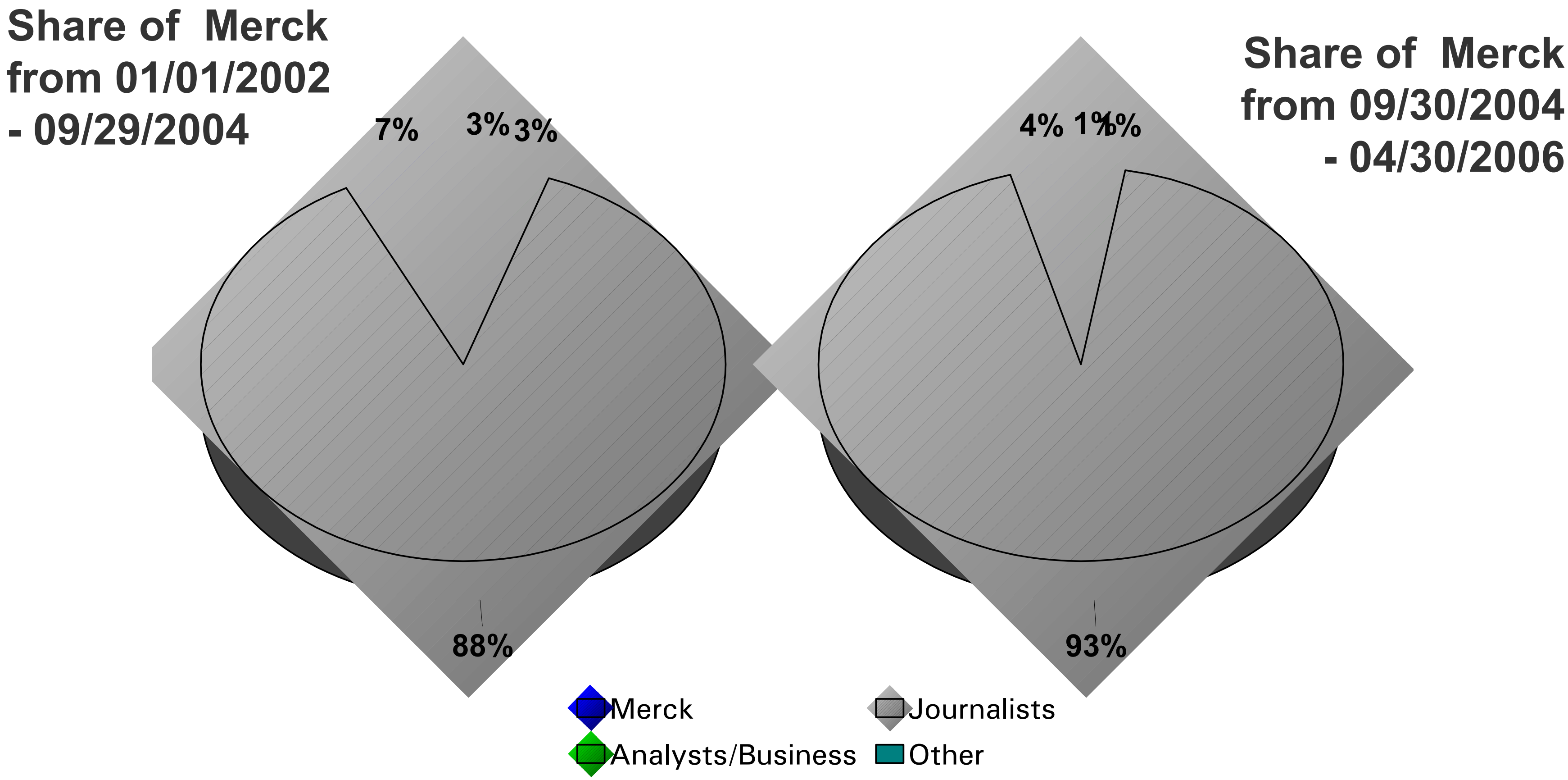
Volume of Coverage and Rating of Merck





Low Media Profile Leaves Open Door for Criticism



The Importance of Corporate Reputation

- Market value is heavily determined by corporate reputation
    - 70-80% of a company's assets are not on the balance sheet
    - Intangibles are increasingly important

- Reputation affects current performance
    - Better employees
    - More loyal customers
    - Better terms and service by vendors
    - Higher-margin products and services

- Reputation affects expected future performance
    - Belief that current performance will continue and improve
    - Less uncertainty about future cash flows

- A good reputation leads to lower perceived risk
    - Lower cost of capital
    - Higher stock price

Understanding Corporate Reputation

Character is like a tree and reputation like a shadow.
The shadow is what we think of it; the tree is the real thing.
Abraham Lincoln

- Reputation is a double-edged sword
  - A good reputation creates value for all stakeholders
  - It also exposes the company to reputational risk

Understanding Corporate Reputation

- Reputation is what is *perceived and believed* by others
  - *Others* include all stakeholders
    - Shareholders
    - Customers
    - Employees
    - Regulators
    - NGOs
  - Reputation is comprised of many category-specific reputations
    - Product quality
    - Corporate governance
    - Customer service
    - Employee relations
    - Intellectual capital
    - Financial performance
    - Environmental awareness

Reputation and Reality

• A company's *reputation* needs to be compared to its underlying *reality* which determines its ability to deliver on the expectations created by its reputation

• When Reputation>Reality the company needs to improve its performance or lower expectations

• When Reality>Reputation the company needs to do a better job of communicating to all of its stakeholders

The Current State of Reputational Risk Management

- No consensus about how to define it
  - A risk category in its own right (52%)
  - A consequence of poorly managing other risks (48%)
- Reputational risk not a part of existing risk management frameworks
  - COSO Enterprise Risk Management Framework
  - Basel II for financial institutions
- Lack of tools and techniques
- No well-defined process for managing it
- No clear views on what constitutes “best practice”

The Current State of Reputational Risk Management

- Lack of clarity within an organization about who is responsible for it
  - CEO bears ultimate responsibility when damage occurs
  - Company is then in crisis mode and reactively rather than proactively managing reputational risk
  - Many possible candidates to have day-to-day responsibility
    - Board of directors
    - COO
    - CFO
    - Business unit heads
    - Risk management
    - Internal audit
    - Compliance
    - General counsel
    - Strategic planning
    - Marketing
    - Corporate communications
  - Rarely is anyone explicitly given this responsibility

The Four Main Determinants of Reputational Risk

Don't consider your reputation and your may do anything you like.

Chinese Proverb

1. Reality gap
   - Reputation exceeds the company's ability to meet expectations
   - Difficult for executives to admit that a reality gap exists
     - Tend to be optimists
     - Are focused on the upside part of risk-taking for creating value

2. Changing external beliefs and expectations
   - Behavior considered acceptable or even laudatory no longer is so
     - Putting friends on the board
     - Managing earnings
   - Beliefs and expectations of all stakeholders have to be considered
   - These changes can emerge over time
   - Can be crystallized by a single event

The Four Main Determinants of Reputational Risk

3. Poor internal coordination
   - Failure to consider reputational risk on other units
   - Failure to consider interaction effects of decisions in different units

4. Top management fraud
   - Affects both personal and corporate reputations when it occurs at the highest level
   - External auditors still resisting accepting responsibility for preventing and detecting fraud
   - Boards are not challenging the auditors to do so

Effectively Managing Reputational Risk

The way to gain a good reputation is to endeavor to be what you desire to appear.

Socrates

- Objectively assess both reality and reputation
- Identify changing beliefs and expectation
- Develop and implement an explicit process
- Detect and prevent fraud by top management

Objectively Assess Both Reality and Reputation

- Strategic media analysis
  - Identify specific elements of reputation
  - Evaluate range and concentration on topic structure
  - Assess company's performance on each
    - Above or below the "Awareness Threshold"
    - Management's "share of voice"
  - Look at company in context of competitors
  - Look at industry in context of other industries
- Evaluate the company's character along the same elements
  - Internal performance measures
  - External benchmarking
    - Competitor
    - "Best in class"

Objectively Assess Both Reality and Reputation

- Benchmark company’s performance against competitors
  - Financial results
    - Extensible Business Reporting Language (XBRL)
    - Visualization software
  - P/E ratio
  - Total return to shareholders

- Do “deep drill down” performance analysis to identify areas of performance risk (visualization software)
  - Identify anomalies and outliers in financial results
    - Extensible Business Reporting Language (XBRL)
    - Visualization software

Objectively Assess Both Reality and Reputation

- When Reality>Reputation need to improve communications
  - Media relations strategy
  - Greater transparency and enhanced business reporting
    - Shareholders
    - Other stakeholders
- When Reputation>Reality need to improve capabilities
- Much of this analysis already being done as “performance management” but needs to be integrated from a reputational risk perspective

Identify Changing Beliefs and Expectations

- Since this is about the future it is not an easy thing to do

- But insights can be gained by accessing multiple data sources using a variety of research methodologies

- Surveys of relevant stakeholders
    - Customers
    - Employees
    - Investors

- Strategic media analysis
    - Agenda Setting
    - Agenda Cutting
    - Advanced search analytics on narrative data

Identify Changing Beliefs and Expectations

- Internal interviews of senior management and functional experts who are "in touch" with the outside world
  - Corporate communications
  - Marketing
  - Investor relations

- Interviews with a wide range of industry and topical experts
  - Create as broad a network of experts as possible
  - Continually look for new and fresh views

- Third-party soundings of NGOs
  - They cannot be ignored
  - They can provide insights about emerging issues in the NGO world and relevant new NGOs

- Again, much of this analysis already being done but needs to be integrated from a reputational risk perspective

Develop and Implement an Explicit Process

- Appoint ONE person to be in charge of developing and managing the process for managing reputational risk

- This is NOT a full time role and should be held by someone with another job

- Who the right person is depends on a company's particular situation based on industry, strategy, and organization
  - Most common choices include
    - COO
    - CFO
    - Chief compliance officer
    - Head of risk management
    - Head of internal audit
    - General counsel
  - Other viable candidates are
    - Head of marketing
    - Head of strategic planning
    - Head of corporate communications

Develop and Implement an Explicit Process

- The right person is NOT the CEO
  - The CEO is responsible for creating value and thinking about the upside
  - Day-to-day analysis of downside reputational risks would be time-consuming and paralyzing
  - CEO is also a key source of reputational risk
  - However, the CEO does have major responsibility when a crisis occurs and reputation is damaged

- The key elements of the process are information sharing and integrated analysis
  - Across all functions and business units
  - Using quantitative and qualitative data of many types
  - Using a wide-range of analytical techniques

- The process should build on existing processes to avoid unnecessary bureaucracy

- Corporate Communications can manage this process if it is willing to take on the challenge

Detect and Prevent Fraud by Top Management

- Top management fraud damages both individual and corporate reputations

- The damages are substantial
  - "Over the past 80 years the only truly serious problem in accounting and financial reporting has been Top Management Fraud." (A retired General Auditor of General Motors, 2004)
  - CEOs and CFOs involved in 80% of fraudulent financial statements (SEC investigations for 1987-1997)
  - Fraud caused more than $600 billion in damages in 2003 (American Association of Fraud Examiners)

- Detecting and preventing fraud was a top priority of the auditing profession at its inception (<u>Auditing: A Practical Matter for Auditors</u> by Lawrence R. Dicksee, 1892)

- Since then auditors have increasingly disavowed responsibility for this

- Yet shareholders still see this as one of their primary responsibilities

Detect and Prevent Fraud by Top Management

- This “Expectation Gap” has to be closed by better auditing, not by managing expectations

- Outside auditors must accept this responsibility

- Boards of directors must insist that they do so
    - In choice of audit firm
    - In setting the scope of the audit

- Insurance companies can support through more favorable prices and terms on Directors and Officers insurance

- Increasing legal liabilities on board members create a real incentive for them to do everything they can to detect and prevent top management fraud

- If you are from a company
  - Find out how reputational risk is being managed
  - Do what YOU can to help make it be more effectively managed
- If you are from the investment community
  - Develop analytical techniques for determining gaps between reputation and reality
  - Take account of these gaps in investment recommendations and decisions
- If you are an advisor
  - Determine how your services can contribute to better management of reputational risk
  - Make these services available to your clients
- If you are a researcher
  - Determine if there are aspects of reputational risk of research interest to you
  - Do the research and publish the results

Cassio says to Othello:

“Reputation, reputation, reputation!
O, I have lost my reputation!
I have lost the immortal part of myself, and what remains is bestial.”

Shakespeare’s *Othello (Act 2, Scene 3)*